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Roy Babitt

Susan Freiman

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## COMMENT

# The Priority of Federal Claims: Selected Problems and Theoretical Considerations

*Roy Babitt and Susan Freiman\**

### I. INTRODUCTION

**W**HEN A DEBTOR'S assets are insufficient to pay all of his creditors in full, the resulting conflict among creditors is resolved through the application of rules of priority. This Article deals with priority rules governing payment to the United States. Its purpose is neither to review all the law in the field nor to decide whether federal priority is *per se* good or bad. Instead, we shall examine the appropriateness of present federal priority law in terms of effectively achieving congressional goals. In doing so, we hope to impart some understanding of how the government as creditor acts and how that action relates to the flow of private commercial credit.

### II. THE INSOLVENCY PRIORITY

One of this country's oldest statutes provides that when the estate of a debtor of the United States is being administered for the benefit of the debtor's creditors, the debts owed to the United States must be paid first.<sup>1</sup> Nearly all cases have held that this statute must be given its plain meaning, and that the government is to be paid first, even before a creditor who holds what would, under state law,

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\* The Authors: Roy Babitt (A.B., LL.B. New York University) is Administrative Referee of the Bankruptcy Court of the Southern District of New York; Susan Freiman (A.B. Bryn Mawr, LL.B. Yale University, LL.M. (in Taxation) New York University) is a practicing attorney in New York, New York and an associate member of the National Bankruptcy Conference. The views expressed herein are solely the personal opinions of the authors and are in no way to be considered official expressions.

<sup>1</sup> 31 U.S.C. § 191 (1970) [hereinafter referred to as Section 191]. The statute derives from Act of March 3, 1797, ch. 20, § 5, 1 Stat. 515, and Act of March 2, 1799, ch. 22, § 65, 1 Stat. 676. It provides:

Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall ex-

be a perfected security interest.<sup>2</sup> The Supreme Court has indicated that only a security interest perfected under *federal* law will defeat the sovereign's absolute priority.<sup>3</sup>

The language of the test used by the Court in determining whether a security interest has been perfected under federal law is peculiar to the insolvency area. A competing lien must be "choate," or "fully perfected and specific." This means that the identity of the creditor, the amount of the debt, and the property subject to the lien must be definite beyond all dispute, and that the creditor must have nothing further to do in order to assert his right to the property. At least in cases involving personal property, this test requires that the creditor have taken actual possession of the property.<sup>4</sup> While under state law the effectiveness of a security interest is tested by reference to whether the debtor and creditor intended to create a security interest and whether other creditors were given notice of the security,<sup>5</sup> the federal test is more stringent in that it

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tend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed.

There are many articles discussing application of this statute and its history. Among the more recent are Lacy, *The Effect of Federal Priority and Tax Lien Legislation on Creditors of Vendors and Purchasers*, 50 ORE. L. REV. 621, 622-37 (1971); Plumb, *The Federal Priority in Insolvency: Proposals for Reform*, 70 MICH. L. REV. 1 (1971). The definitive work in the field is, of course, the three-part article by Plumb, *Federal Liens and Priorities — Agenda for the Next Decade*, 77 YALE L.J. 228, 605, 1104 (1967-68).

<sup>2</sup> When the competing interest prevails, it generally does so because the court has concluded that the case is not one to which section 191 applies. For example, in *United States v. Saidman*, 231 F.2d 503, 508-10 (D.C. Cir. 1956), the District of Columbia was paid its taxes ahead of the United States. The court reasoned that Congress intended its later and more specific legislation, under which the District made its claim, to prevail over the earlier, general insolvency statute.

<sup>3</sup> The Court has never strictly held that a security interest that passes the test for perfection under federal law would defeat the priority, because it has not yet found any lien that passed the stringent federal requirements. However, in *United States v. Crest Fin. Co.*, 368 U.S. 347 (1961), the Court accepted a concession by the United States that the competing creditors had a choate lien. The security interest in *Crest Finance* was an assignment of accounts receivable securing a contemporaneously made loan. Notice of the assignment had been given to the account debtors, an action that under other circumstances would be equivalent to transferring possession. See, e.g., N.Y. CIV. PRAC. LAW § 5232 (McKinney 1963), providing that a levy upon intangible personal property is made by delivering a notice to the account debtor.

<sup>4</sup> *Illinois ex rel. Gordon v. Campbell*, 329 U.S. 362 (1946).

<sup>5</sup> UNIFORM COMMERCIAL CODE §§ 9-203(1), -302, -303 [hereinafter cited as UCC]. There are, of course, other kinds of statutory security interests, such as the familiar mechanic's lien and artisan's lien, created to protect certain classes of creditors favored by state legislatures. New York even has a lien for service of stallions or bulls. N.Y. LIEN LAW § 160 (McKinney 1966). For the purpose of this article, however, when reference is made to a lien or security interest, we mean a consensual lien, that is, a lien created by the consent of the parties to the contract.

renders liens ineffective so long as contingencies exist which, even though remote, are theoretically possible.<sup>6</sup>

Furthermore, the choateness requirement is applied to private liens in competition with a federal claim but not to the federal claim itself. Section 191 speaks of "debts" due the government, so there is no need for the government to establish anything more than an unpaid obligation.<sup>7</sup> It is not even necessary that the debt be certain. In *United States v. 58th Street Plaza Theatre, Inc.*,<sup>8</sup> for example, the United States recovered a transfer to creditors as to whom the United States had priority under section 191, although at the time of the transfer the debtor was solvent and there was not yet any obligation to pay the government.<sup>9</sup> This was, to be sure, an extreme case, since the transfer was a fraudulent conveyance to the taxpayer's director, wife, and children, all of whom were stockholders.<sup>10</sup>

The amount of the debt owing to the government under section 191 is measured as of the date of the insolvency proceeding, without regard to subsequent events.<sup>11</sup> This rule might appear to state the obvious, but consider subsequent events that would, given other circumstances, entitle the debtor to a credit against his federal liability. The Supreme Court dealt with such a situation in *Massachusetts v. United States*,<sup>12</sup> a case involving liability for federal unemployment taxes (FUTA). The Internal Revenue Code provides that an employer is entitled to a credit against the federal tax (the

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<sup>6</sup> The contingency that defeats perfection can be very remote indeed. In *United States v. Scovil*, 348 U.S. 218 (1955), the Supreme Court held a lien to be inchoate where an insolvent debtor had but two days within which it could post a bond to free property seized by the debtor's landlord. See also *United States v. Waddill, Holland & Flinn, Inc.*, 323 U.S. 353, 357-58 (1941), where the Court said "[c]onceivably the amount of rent due was uncertain on the day of the assignment [for the benefit of creditors]. The landlord may have been mistaken as to the rental rate or as to payments previously made and the tenant may have been entitled to a set-off."

<sup>7</sup> *United States v. New Britain*, 347 U.S. 81, 85 (1954).

<sup>8</sup> 287 F. Supp. 475 (S.D.N.Y. 1968).

<sup>9</sup> The expansive definition of debt which permitted the United States to recover is by no means unique to the federal priority statute. See N.Y. DEBT. & CRED. LAW § 270 (McKinney 1945), which defines "creditor" as one who has "any claim, whether matured or unmatured, liquidated or unliquidated, absolute, fixed or contingent." See also Bankruptcy Act § 307, 11 U.S.C. § 707 (1970).

<sup>10</sup> 287 F. Supp. at 498. Cf. *Pepper v. Litton*, 308 U.S. 295 (1939), which suggests a firmer basis for the ruling.

<sup>11</sup> *Hatch v. Morosco Holding Co.*, 61 F.2d 944 (2d Cir. 1932), cert. denied, 288 U.S. 613 (1933).

<sup>12</sup> 333 U.S. 611 (1948).

FUTA credit) if payments are made for state unemployment taxes. The amount of the credit is reduced if the state is not paid on time, but the credit is not forfeited by that default.<sup>13</sup> When the taxpayer in this case filed an assignment for the benefit of creditors pursuant to a state insolvency proceeding, neither the state nor the federal unemployment tax had been paid. The Supreme Court held that section 191 required the federal taxes to be paid in full, and further, that section 191 precluded all right to any credit for amounts subsequently paid to the state. The rationale for the Court's conclusion seems reasonable: "It is at least doubtful on the statute's wording that obligations wholly contingent for ultimate maturity and obligation upon the happening of events after insolvency can be said to fall within the reach of 'debts due' as of the time of insolvency."<sup>14</sup>

The *Massachusetts* case has been criticized,<sup>15</sup> and it does lead to anomalous results. The case rests on section 191, which is inapplicable in bankruptcy proceedings because it is inconsistent with the specific priority rules mandated by the Bankruptcy Act.<sup>16</sup> The FUTA credit is, therefore, available to estates being administered in bankruptcy but not in other types of insolvency proceedings.<sup>17</sup> There may well be reasons for Congress to prefer that estates of federal debtors be administered under the supervision of federal judicial officers, but it is doubtful that the best way to achieve this result is by encouraging debtors to go into bankruptcy through the use of a tax credit against unemployment taxes.

In summary, therefore, the absolute federal insolvency priority contained in section 191 creates several anomalies. Before evaluating the effect of this provision, and of the federal priority generally, we turn to a discussion of other bases of federal priority.

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<sup>13</sup> INT. REV. CODE OF 1954, § 3302.

<sup>14</sup> 333 U.S. at 626-27.

<sup>15</sup> *The Federal Priority in Insolvency*, *supra* note 1, at 71-79.

<sup>16</sup> Bankruptcy Act § 64(a), 11 U.S.C. § 104(a) (1970).

<sup>17</sup> The FUTA credit is not the only instance in which the payment of claims is affected by the choice of proceeding. In bankruptcy, federal taxes share pro rata with state and local taxes, which must be paid in full before any payment is made on non-tax debts of the United States, while in other types of insolvency proceedings, state and local taxes in certain circumstances take priority over a federal tax claim. INT. REV. CODE OF 1954, § 6323(b) (6) (A); Bankruptcy Act §§ 64(a) (4)-(5), 11 U.S.C. §§ 104(a) (4)-(5) (1970). A more sympathetic case can be made for wage earners, who in bankruptcy are accorded second priority, but in non-federal insolvencies are given no priority over the United States. *In re Kupshire Coats, Inc.*, 272 N.Y. 221, 5 N.E.2d 715 (1936); Bankruptcy Act § 64(a) (2), 11 U.S.C. § 104(a) (2) (1970).

### III. THE FEDERAL PRIORITY UNDER THE INTERNAL REVENUE CODE

#### A. *Background of the Tax Lien Act of 1966*

When a tax is assessed,<sup>18</sup> the amount of the liability becomes a "lien"<sup>19</sup> on all the nonexempt<sup>20</sup> property of the taxpayer.<sup>21</sup> Unless the defaulting taxpayer obtains a discharge in bankruptcy of his tax debt,<sup>22</sup> or the Internal Revenue Service (IRS) has allowed the statute of limitations on collection to expire,<sup>23</sup> the lien will continue to encumber the taxpayer's present and future property<sup>24</sup> until the liability is satisfied. Moreover, even though no notice is filed publicly, the lien will defeat the claims of other creditors of the taxpayer unless the other creditor is able to establish that he is within one of the classes of creditors protected by section 6323 of the Internal Revenue Code.<sup>25</sup>

The status and overall effect of federal tax liens was recently examined by Congress when it enacted the Tax Lien Act of 1966.<sup>26</sup> As the Act's framers saw it, that statute was to be the first comprehensive revision of the internal revenue laws concerning the relationship of federal tax liens to the interests of other creditors.<sup>27</sup> Some courts have since gone further than Congress and construed

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<sup>18</sup> An assessment is the entry of an amount of the liability on the dockets of the Internal Revenue Service. INT. REV. CODE OF 1954, § 6203.

<sup>19</sup> We shall not discuss the problems encountered in attempting to define "lien" until the end of this article, after we have prepared the reader for some of the problems involved. See notes 184-85 *infra* & accompanying text. For present purposes, a useful definition is that we are dealing with a "lien" rather than a mere "priority" if the creditor's rights in specific property are enforceable regardless of the debtor's financial condition. *In re J. R. Nieves & Co.*, 446 F.2d 188, 190 (1st Cir. 1971). It should be observed, however, that this distinction is less useful than it might be, as the creditor's concern arises because of the debtor's financial condition. See *H.B. Agsten & Sons, Inc. v. Huntington Trust & Sav. Bank*, 388 F.2d 156, 161-62 (4th Cir. 1967) (Haynsworth, J., concurring).

<sup>20</sup> INT. REV. CODE OF 1954, § 6334.

<sup>21</sup> *Id.* § 6321.

<sup>22</sup> Most tax debts cannot be discharged. Bankruptcy Act § 17(a)(1), 11 U.S.C. § 35(a)(1) (1970).

<sup>23</sup> INT. REV. CODE OF 1954, § 6502-03. If the statute is about to expire, the government may sue to reduce the claim to judgment, under *id.* § 7403. The time to collect that judgment is governed by the laws of the various states. FED. R. CIV. P. 69.

<sup>24</sup> *Glass City Bank v. United States*, 326 U.S. 265 (1945).

<sup>25</sup> INT. REV. CODE OF 1954, § 6323.

<sup>26</sup> Act of Nov. 2, 1966, Pub. L. No. 89-719, 80 Stat. 1125 (codified in scattered sections of INT. REV. CODE OF 1954).

<sup>27</sup> S. REP. NO. 1708, 89th Cong., 2d Sess. (1966); 1966 U.S. CODE CONG. & AD. NEWS 3722.

this tax legislation as permitting subordination of non-tax federal claims.<sup>28</sup>

The dominant purpose of the 1966 legislation was to make the relevant lien provisions of the Internal Revenue Code conform to the concepts developed in the Uniform Commercial Code (UCC) in an attempt to deal with "a multitude of technical problems."<sup>29</sup> As the UCC was itself called for by the evolution of business practices involving protection for secured creditors not previously protected, so Congress thought it desirable to make the lien provisions of the tax laws conform with those business concepts developed under state law.<sup>30</sup>

Pre-1966 law gave purchasers and certain categories of secured creditors priority over a tax lien until notice of such lien was filed in accordance with state law filing statutes. These priority creditors were limited to mortgagees, pledgees, purchasers, and judgment creditors, with additional protection given to mortgagees and pledgees of securities and to purchasers of motor vehicles.<sup>31</sup> The main impulse of the 1966 legislation was to improve the status of private secured creditors by: (1) extending protection against unfilled tax liens to mechanic's lienors; (2) providing a clear definition of certain classes of secured creditors already protected regardless of choateness at the time notice of the tax lien is filed; (3) broadly increasing the classes of creditors holding property interests for whom super-priority was to be given even against a noticed tax lien;<sup>32</sup> (4) giving priority status to certain interests created even after filing of a tax lien if they arise under specified types of financing agreement entered into before filing of the tax lien; and (5)

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<sup>28</sup> See text accompanying notes 72-89 *infra*.

<sup>29</sup> S. REP. NO. 1708, 89th Cong., 2d Sess. 2 (1966), *reprinted in* 1966 U.S. CODE CONG. & AD. NEWS 3722-23.

<sup>30</sup> *Id.* at 2, 1966 U.S. CODE CONG. & AD. NEWS at 3723.

<sup>31</sup> Int. Rev. Code of 1954, §§ 6321-23, 68A Stat. 779; Int. Rev. Code of 1939, §§ 3670-72, 53 Stat. 448. See S. REP. NO. 1708, 89th Cong., 2d Sess. 2 (1966), *reprinted in* 1966 U.S. CODE CONG. & AD. NEWS 3722, 3723.

<sup>32</sup> Super-priority was extended to purchasers of tangible personal property sold at retail in the ordinary course of the seller's business, to repairmen of tangible personal property, to attorney's liens for reasonable fees, and to insurance companies to the extent of policy loans made to an insured. Beyond this, super-priority was also extended to casual purchasers of tangible personal property from a nondealer involving a sales price of less than \$250, and to banks and building and loan associations with regard to passbook loans, where the purchaser or the bank or building and loan association was without actual knowledge of a filed tax lien.

providing a time period up to forty-five days for further protection of some security interests after filing of notice of the tax lien.<sup>33</sup>

### B. *Other Legislation Subordinating Federal Claims*

Subordination of federal claims under the Internal Revenue Code can be best understood in the context of other existing legislation subordinating governmental priorities. Such legislation is not new.<sup>34</sup> For example, 31 U.S.C. section 203<sup>35</sup> provides that no liability of an assignor to the United States or one of its departments or agencies, regardless of how such liability arose, shall create any liability on the assignee of the claim to make restitution, refund, or repayment to the government of any amount the assignee might have received under the assignment. This statute was designed to facilitate the financing of defense contracts by banks and other lending institutions.<sup>36</sup>

Another example is 15 U.S.C. section 646<sup>37</sup> which subordinates a security interest of the Small Business Administration (SBA) to a lien for local property taxes, if that property tax lien would, under local law, be superior to a privately held security interest. This subordination was endorsed by the SBA, with the approval of the Bureau of the Budget, and was designed to treat the SBA like a private creditor in relation to local governmental units.<sup>38</sup>

The Bankruptcy Act also reflects congressional decisions to favor particular industries at the expense of a uniform scheme for distribution of a debtor's assets. As early as 1935 Congress decided to facilitate the financing of railroad equipment acquisitions by amending section 77(j) of the Bankruptcy Act<sup>39</sup> to permit certain sellers and lessors of equipment to repossess equipment despite the com-

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<sup>33</sup> S. REP. NO. 1708, 89th Cong., 2d Sess. 3 (1966), *reprinted in* 1966 U.S. CODE CONG. & AD. NEWS 3722, 3723-24.

<sup>34</sup> Kennedy, *The Relative Priority of the Federal Government*, 63 YALE L.J. 905, 927 n.128 (1954).

<sup>35</sup> Act of May 15, 1951, ch. 75, 65 Stat. 41, *amending* Assignment of Claims Act of 1940, ch. 779, 54 Stat. 1029.

<sup>36</sup> S. REP. NO. 217, 82d Cong., 1st Sess. 1 (1951). *See also* 41 U.S.C. § 15 (1970), (as amended by Act of May 15, 1951, ch. 75, 65 Stat. 41).

<sup>37</sup> 15 U.S.C. § 646 (1970).

<sup>38</sup> S. REP. NO. 1714, 85th Cong., 2d Sess. (1958), *reprinted in* 1958 U.S. CODE CONG. & AD. NEWS 3080. Congress intended to limit the government's claim against particular assets by subordinating its claim to local taxes on those assets. *See also* CONFERENCE REPORT, STATEMENT OF THE MANAGERS ON THE PART OF THE HOUSE, *id.* at 3084.

<sup>39</sup> 11 U.S.C. § 205(j) (1970), (as amended by Act of Sept. 4, 1957, Pub. L. No. 85-295, 71 Stat. 617).



mencement of bankruptcy proceedings,<sup>40</sup> even though the bankruptcy court could stay all other secured creditors.

Congress exhibited a similar desire to benefit an individual industry when it amended section 116 of chapter X of the Bankruptcy Act to extend this favored treatment to creditors who had financed aircraft and aircraft equipment.<sup>41</sup> Congress found justification in the financial problems facing many of the nation's smaller airlines that needed to replace obsolete equipment. The legislative history discloses Congress' feeling that the amendment would result in an increased availability of capital.<sup>42</sup> The amendment permitted parties to a lease or a conditional sales contract involving aircraft and aircraft equipment to agree to waive the applicability of chapter X proceedings insofar as such proceedings might affect title and right to possession. Accordingly, in the event of default and bankruptcy, the right of the secured creditor to take possession was protected against the bankruptcy court's injunctive power.

A later amendment to section 116<sup>43</sup> extended favored status to vessels utilized by any water carrier holding a certificate of public convenience and necessity or a permit issued by the Interstate Commerce Commission. While the Commission, the Department of Transportation, and the Bureau of the Budget all supported this amendment, the support of the Bureau of the Budget was conditioned on an understanding that the Bill would not affect current procedure for the filing of federal tax liens against property of a delinquent taxpayer. The legislative history reveals Congress' intention not to alter the tax lien procedure established in the internal revenue laws.<sup>44</sup>

### C. *Judicial Determinations of Federal Government Priority*

Even where express congressional subordination cannot be found, the courts have not been loath to trench on the revenue pow-

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<sup>40</sup> H.R. REP. NO. 1283, 74th Cong., 1st Sess. (1935); S. REP. NO. 1336, 74th Cong., 1st Sess. (1935).

<sup>41</sup> 11 U.S.C. § 516(5) (1970).

<sup>42</sup> H.R. REP. NO. 944, 85th Cong., 1st Sess. 2 (1957).

<sup>43</sup> 11 U.S.C. § 516(6) (1970); Act of Oct. 17, 1968, Pub. L. No. 90-586, § 2, 82 Stat. 1149.

<sup>44</sup> S. REP. NO. 1094, 90th Cong., 2d Sess. (1968); H.R. REP. NO. 1932, 90th Cong., 2d Sess. (1968). Interestingly, the Congress that passed the 1966 Tax Lien Act exhibited less tenderness for the tax gatherer. In dealing with tax lien subordination to the "casual" purchaser involving a sale for a price of less than \$250, Congress expressed an intention that the IRS not pursue "casual" sales involving more than \$250 if it would not have done so before the 1966 Act. S. REP. NO. 1708, 89th Cong., 2d Sess. 5 (1966), *reprinted in* 1966 U.S. CODE CONG. & AD. NEWS 3722, 3726.

er where a strong societal need has been demonstrated. Thus the government has sometimes lost cases in which specific legislation designed to achieve a desired end or overcome a specific mischief has collided with a statute of broad general applicability such as section 191.<sup>45</sup>

In *United States v. Guaranty Trust Co.*,<sup>46</sup> for example, the Supreme Court dealt with the applicability of section 191 to a claim arising under title II of the Transportation Act of 1920.<sup>47</sup> The Court concluded, despite Congress' silence on the subject, that "the entire spirit of the Act makes clear the purpose" that the indebtedness arising under the Transportation Act was meant to be excluded from the reach of section 191.<sup>48</sup> Title II authorized government financing to protect the existing transportation system, and the Court feared that giving priority to the government over other creditors under section 191 would defeat that protective purpose. Thus while the United States was accorded priority over unsecured creditors, the Court concluded it was entitled to no priority over secured and other preferred creditors. The Court did not further elaborate, however, on which creditors were to be protected against the government's priority.

In another case, *Mellon v. Michigan Trust Co.*,<sup>49</sup> the Court was faced with a claim by the Director General of Railroads that section 191 entitled the government to a priority on the debtor's voluntary assignment of its assets. The Court rejected that contention and concluded that section 10 of the Federal Control Act<sup>50</sup> foreclosed a holding that the government was entitled to section 191 priority merely because it exercised overall supervisory control over the nation's railroads. The Court said that such federal control was not meant to alter the substantive rights of parties "as they would have existed but for federal control."<sup>51</sup>

In a third case, *Cook County National Bank v. United States*,<sup>52</sup> the Supreme Court concluded that section 191 was not applicable to government claims against insolvent national banks. The Court

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<sup>45</sup> 31 U.S.C. § 191 (1970). See text accompanying notes 1-17 *supra*.

<sup>46</sup> 280 U.S. 478 (1930).

<sup>47</sup> Act of Feb. 28, 1920, ch. 91, §§ 200-11, 41 Stat. 456.

<sup>48</sup> 280 U.S. at 485.

<sup>49</sup> 271 U.S. 236 (1926).

<sup>50</sup> Act of March 31, 1918, ch. 25, § 10, 40 Stat. 451.

<sup>51</sup> 271 U.S. at 239.

<sup>52</sup> 107 U.S. 445 (1882).

based its decision on its view that the national bank legislation was a separate code, neither limited nor enlarged by other statutory provisions respecting claims against insolvents. The Court said that a law embracing an entire area, dealing with all its phases, withdraws the subject from the operation of a general statutory provision<sup>53</sup> such as section 191.<sup>54</sup>

The courts have not always been consistent, however, in respecting the strong social needs that lay at the core of the enactment of some of the statutes we have touched upon, but instead have sometimes attempted to construe the language of particular legislation in such a way as to accommodate its purpose with that of section 191. In *In re Lehigh Valley Mills, Inc.*,<sup>55</sup> for example, the Court of Appeals for the Third Circuit, finding that the SBA is an integral part of the federal government and entitled to the priority of the sovereign,<sup>56</sup> concluded that section 17 of the Small Business Administration Act<sup>57</sup> did not operate to subordinate the SBA loan to the payment of state taxes. The court held that Pennsylvania capital stock, corporate income, and corporate loan taxes were not taxes on property within the meaning of 15 U.S.C. section 646 and were, therefore, not entitled to priority over the SBA claim.<sup>58</sup>

Similarly, the same court in *United States v. Oswald & Hess Co.*,<sup>59</sup> concluded that apart from the question of choateness, local water and sewage charges were not taxes due on property within the meaning of 15 U.S.C. section 646, and accordingly could not defeat the federal government's priority. The Tenth Circuit, however, focusing more squarely on the issue, gave a chattel mortgage held by the SBA priority over a state tax lien on the ground that the federal mortgage was fully choate.<sup>60</sup>

In *United States v. Emory*<sup>61</sup> the Supreme Court dealt with section 191 in the context of a state court equity receivership involv-

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<sup>53</sup> *Id.* at 451.

<sup>54</sup> A typical example of specific legislation superseding section 191 is Bankruptcy Act § 64(a), 11 U.S.C. § 104(a) (1970), fixing priorities of creditors including the national sovereign in bankruptcy proceedings.

<sup>55</sup> 341 F.2d 398 (3d Cir. 1965).

<sup>56</sup> See *SBA v. McClellan*, 364 U.S. 446, 450 (1960).

<sup>57</sup> 15 U.S.C. § 646 (1970).

<sup>58</sup> The SBA argued that section 191 applied to give the federal government priority, but the court did not find it necessary to reach the question. 341 F.2d at 401.

<sup>59</sup> 345 F.2d 886 (3d Cir. 1965).

<sup>60</sup> *Director of Revenue v. United States*, 392 F.2d 307, 313 (10th Cir. 1968).

<sup>61</sup> 314 U.S. 423 (1941).

ing application of the National Housing Act, as amended.<sup>62</sup> The Court ruled that section 191 is to be construed liberally to effectuate its purpose, which the Court defined as the securing of adequate public revenue to sustain the burden of government.<sup>63</sup> The Court, therefore, concluded that nothing in the National Housing Act was designed to take away the priority conferred by section 191.<sup>64</sup> The Court saw no inconsistency between the National Housing Act and section 191. The private creditor argued unsuccessfully that section 191 should not apply because its effect would be to chill the extension of credit to private borrowers. The Court felt that this could be true as to all claims of the United States and saw no reason to amplify the plain reach of the special legislation to defeat the section 191 priority. The majority also rejected an argument that section 64(a) of the Bankruptcy Act<sup>65</sup> expressed a general purpose to subordinate federal claims, concluding that that priority statute applies only in bankruptcy proceedings.<sup>66</sup>

Four Justices, led by Mr. Justice Reed, disagreed.<sup>67</sup> They reasoned that in all likelihood the 1934 Congress which passed the National Housing Act gave no thought to section 191, and that the true legislative purpose could not be gleaned from a mere reading of the statutes *in pari materia*. Rather, the dissenters asserted that the purpose of the later National Housing Act should be gleaned from general expressions of purpose and then compared to judicial interpretations of the reach of section 191. On that premise they concluded that section 191 was generally inapplicable in cases involving public financing legislation where the claims of creditors were in competition with the national sovereign's entitlement.

Finally, in *United States Department of Agriculture v. Re-mund*,<sup>68</sup> the Court was concerned with claims of the Farm Credit Administration asserted in a state probate proceeding. The Court read the Farm Credit Act<sup>69</sup> as a statute calling for emergency financial relief to distressed farmers having nothing to do with restora-

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<sup>62</sup> Act of June 27, 1934, ch. 847, 48 Stat. 1246.

<sup>63</sup> 314 U.S. at 426.

<sup>64</sup> *Id.* at 430-33.

<sup>65</sup> 11 U.S.C. § 104(a) (1970).

<sup>66</sup> 314 U.S. at 428-29.

<sup>67</sup> *Id.* at 433.

<sup>68</sup> 330 U.S. 539 (1947).

<sup>69</sup> Act of Feb. 23, 1934, ch. 23, 48 Stat. 354; Act of June 19, 1934, ch. 648, 48 Stat. 1021, 1056.

tion of their credit status. Accordingly, the Court concluded, there was no prohibition against applying section 191 against other claims.

#### D. *The Tax Lien Act of 1966 and Non-Tax Liens*

The 1966 Congress, which enacted the Federal Tax Lien Act, appeared ready to accept "equitable limitations on the priority of Federal tax liens,"<sup>70</sup> but the language of the legislation went no further than to subordinate federal tax liens in nonbankruptcy or noninsolvency cases.<sup>71</sup> A troublesome aspect of this legislation is the manner in which the judiciary has applied it to liens other than tax liens.

In *H.B. Agsten & Sons, Inc. v. Huntington Trust & Savings Bank*,<sup>72</sup> the Court of Appeals for the Fourth Circuit concluded that the SBA was entitled to priority over a mechanic's lien that was inchoate at the time the SBA made its loan to the debtor. The court construed the language and history of the statute and held that the Tax Lien Act subordinated only unrecorded federal tax liens and not other federal claims.<sup>73</sup> The court of appeals read the 1966 legislation as one of a series designed to effect precisely limited expansions of the category of secured creditors protected from secret

<sup>70</sup> *The Federal Priority in Insolvency*, *supra* note 1, at 9.

<sup>71</sup> In 1966, Congress enacted amendments to the Bankruptcy Act restricting the government's priority. The amendment to section 70(c), 11 U.S.C. § 110(c) (1970), achieved, among other things, what *United States v. Speers*, 382 U.S. 266 (1965), had effected a year earlier when the Court invalidated an unfiled tax lien against a trustee in bankruptcy. Act of July 5, 1966, Pub. L. No. 89-495, § 5, 80 Stat. 269. The amendments to sections 17(a) and 64(a)(4), 11 U.S.C. §§ 35(a), 104(a)(4) (1970), limited the priority of tax claims to taxes which became "legally due and owing" within the three years preceding the bankruptcy. Act of July 5, 1966, Pub. L. No. 89-496, §§ 2, 3, 80 Stat. 270. There is much doubt about what that means. See, e.g., *In re Able Roofing & Sheet Metal Co.*, 425 F.2d 699 (5th Cir. 1970); *In re Layton Jewelers, Inc.*, 332 F. Supp. 1153 (S.D.N.Y. 1971); *In re Kopf*, 299 F. Supp. 182 (E.D.N.Y. 1969). Many kinds of taxes are, however, expressly excepted from discharge and therefore remain entitled to priority. See Bankruptcy Act §§ 17(a)(1) (a)-(e), 64(a)(4), 11 U.S.C. §§ 35(a)(1) (a)1(e), 104(a)(4) (1970). In the experience of the authors, nearly all tax claims in bankruptcy cases fall within one of these exceptions and therefore are accorded priority.

<sup>72</sup> 388 F.2d 156 (4th Cir. 1967), *cert. denied*, 390 U.S. 1025 (1968).

<sup>73</sup> The Court of Appeals for the Second Circuit reached the same result in *United States v. General MacArthur Senior Village, Inc.*, 470 F.2d 675, 678-79 (2d Cir. 1972), stating:

We are unable to conclude, however, that a congressional enactment, carefully drawn, which affects the priority of federal tax liens leaves the courts free to disregard prior precedents and thus to broadly extend the scope of the statute's principle to other unspecified areas which, though somewhat analogous, were simply not addressed by the Congress.

federal tax liens, finding that it was not illogical for Congress to retain priority for money actually lent by the government, while at the same time relinquishing its priority for its tax liens, which do not represent financial outlay but rather are predicated on taxpayer delinquency.

A separate concurring opinion<sup>74</sup> concluded that if it were not for the impact of *United States v. Vermont*,<sup>75</sup> there would be serious question whether section 191 even survived the enactment of the Tax Lien Act. In *United States v. Vermont* the Supreme Court had concluded that section 191 was applicable in insolvency cases, but that where there was no insolvency, Congress had failed to provide expressly for federal priority.<sup>76</sup> Similarly, in *Ault v. Harris*<sup>77</sup> the court was unable to perceive any reason why, in a dispute between a mechanic's lienor and the SBA, it should apply a rule more stringent than that which Congress thought desirable in the tax field under the Tax Lien Act.

An issue in *Connecticut Mutual Life Insurance Co. v. Carter*<sup>78</sup> was whether a Farmers Home Administration (FHA) loan had priority over a claim for attorney's fees expressly provided for in a first mortgage to which the FHA loan was admittedly subject. The government<sup>79</sup> urged, on the authority of *United States v. New Britain*,<sup>80</sup> that the first mortgagee's lien for attorneys' fees was not choate and that, accordingly, the FHA claim was superior. The government noted that the choateness of lien test, although originating in the tax lien area, had been extended to subordinate liens which were superior under state law to nontax mortgages held by the federal government.<sup>81</sup>

The court, however, emphasized the fact that the FHA voluntarily took its second mortgage in full awareness of the attorneys' fees clause in the first mortgage. In the absence of what it termed "binding legal precedent,"<sup>82</sup> the court looked to the Tax Lien Act for guidance. Recognizing that "the 1966 Amendment does not of

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<sup>74</sup> 388 F.2d at 161.

<sup>75</sup> 377 U.S. 351 (1964).

<sup>76</sup> *Id.* at 358.

<sup>77</sup> 317 F. Supp. 373 (D. Alas. 1968), *aff'd mem.*, 432 F.2d 441 (9th Cir. 1970).

<sup>78</sup> 446 F.2d 136 (5th Cir.), *cert. denied*, 404 U.S. 857 (1971).

<sup>79</sup> The Farmers Home Administration is a branch of the federal government. 446 F.2d at 138.

<sup>80</sup> 347 U.S. 81 (1953), discussed in text accompanying notes 96-98 *infra*.

<sup>81</sup> 446 F.2d at 138-39.

<sup>82</sup> *Id.* at 139.

itself affect the priority of the claims here involved,"<sup>83</sup> the court nonetheless felt that that statute diminished the vitality of the choateness of lien test in the tax field. That being postulated, the *Connecticut Mutual* court concluded that it would be contrary to its view of Congress' purpose to allow a money-lending agency of the government with a mortgage lien to prevail in a case where, had the government held a tax lien, it would have subordinated its interest on a broader front.<sup>84</sup> Accordingly, the court approved priority for the attorneys' fees under the first mortgage. The dissent vigorously opposed this extension of the Tax Lien Act to include non-tax mortgage liens, concluding that such a step was a matter for the legislature.<sup>85</sup>

There is something to be said for the position of some courts that the sovereign's generosity expressed in the 1966 tax statute should be extended to all cases where the government or a federal agency is a claimant, save for insolvency where section 191 would govern. But the focus of the 1966 legislation and the limited reach of specific legislation touching some government priorities indicate that Congress was not yet prepared to go so far. There is a vast difference between a tax lien asserted because a taxpayer has been delinquent in paying his share of the revenues needed to run the government and a lien securing a financial interest obtained by the government's extension of funds "out-of-pocket."<sup>86</sup> For tax debts the government is an involuntary creditor, since it never chose to lend money to the defaulting taxpayer and did not enter into the transaction in the hopes of making a profit. Although it is arguable that the IRS assumes the risk of loss when it allows delinquencies to continue, as a practical matter this argument is not persuasive. The government cannot begin to police all taxpayers as closely as that hypothesis requires. In contrast, for debts created by the government in its capacity as a lender, such as loans made by the SBA, policy considerations more closely support treating the government like other lenders. Similarly, debts arising out of breach of government contracts are closely analogous to private breach of contract claims. Not only is the government acting rather

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<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> *Id.* at 141-43.

<sup>86</sup> It is suggested in *H.B. Agsten & Sons* that Congress may have intended to protect loans, rather than tax losses which do not involve spending by the government, and that that purpose might reconcile the enactment of the Tax Lien Act with failure to amend section 191. 388 F.2d at 160.

than being acted upon, but it has the option to structure the transaction so as to obtain protection, an option not available when a taxpayer makes the unilateral, secret choice not to pay his taxes.<sup>87</sup>

Apparently Congress' mood in the last few years has been to forego some federal revenue for the sake of the vitality of the commercial world. Yet despite its mood, Congress has gone only so far and, as the dissent in *Connecticut Mutual*<sup>88</sup> points out, when courts apply a tax lien statute to areas that Congress did not intend it to cover, they tread on Congress' power to determine the extent of its bounty. If Congress meant to go as far as some commentators have suggested and some courts have held, then an overhaul of section 191 is clearly in order in insolvency cases as well.<sup>89</sup>

#### E. *The Internal Revenue Code versus Section 191*

There is also some uncertainty concerning the relationship of section 191 to the Tax Lien Act. One question is whether the Internal Revenue Code is the exclusive statute for tax priorities, or whether section 191 will apply if a taxpayer is insolvent. There is, in addition, some doubt whether principles established under section 191 to test choateness are to be used under the Internal Revenue Code.

Because a creditor's rights do not spring into existence fully mature, and because most of the creditors favored by Internal Revenue Code section 6323<sup>90</sup> are so favored only if they have achieved a preferred status before the tax lien is filed, problems arise in determining whether the competing creditor has achieved section 6323 status before tax lien filing. Supreme Court cases decided before enactment of the 1966 Tax Lien Act made it extremely difficult for a creditor to take advantage of the protection that the Internal Revenue Code seemed to give because the Court imported the requirement of choateness from section 191 into the pre-1966 tax lien area.

For example, in *United States v. Security Trust & Savings Bank*,<sup>91</sup>

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<sup>87</sup> Cf. *Bethlehem Steel Corp. v. Foley*, 399 F.2d 314 (2d Cir. 1968), in which the court recognized that "if the materialmen [the creditors who lost the case] wish to establish priorities in these uninstalled materials and protection from federal tax liens, they may still avail themselves of the contractual secured interests which are protected under [INT. REV. CODE OF 1954] § 6323." *Id.* at 318.

<sup>88</sup> 446 F.2d at 141-43.

<sup>89</sup> *The Federal Priority in Insolvency*, *supra* note 1, at 93-108.

<sup>90</sup> INT. REV. CODE OF 1954, § 6323.

<sup>91</sup> 340 U.S. 47 (1950) (involving Int. Rev. Code of 1939, ch. 36, §§ 3670-72, 53 Stat. 448, which is substantially the same as Int. Rev. Code of 1954, ch. 64, §§ 6321-23, 68A Stat. 779, before amendment by the Tax Lien Act of 1966, Pub. L. No. 89-719, § 6323, 80 Stat. 1125).



a federal tax lien was recorded after a private creditor's attachment lien had been filed against the debtor's real estate, but before the attaching creditor had obtained judgment. The Court held that the private lien was inchoate, or contingent, because "[n]umerous contingencies might arise that would prevent the attachment lien from ever becoming perfected by a judgment awarded and recorded."<sup>92</sup> Although the private creditor had a judgment good against everyone else, "[h]e had a mere 'caveat of a more perfect lien to come' "<sup>93</sup> vis-à-vis the federal government. The Court rested its holding squarely on section 191, saying that in insolvency such a lien would not be sufficient to defeat the government's claim.<sup>94</sup> In other words, under one reading of the case, a lien must be choate under the section 191 test before a federal tax lien is filed or it will be defeated by the government, irrespective of whether it qualifies under section 6323. This reading would nullify section 6323 in cases of insolvency. A more reasonable interpretation of the case is that a creditor must achieve section 6323 status before the tax lien is filed, and that it is not enough for the creditor to file a notice that it expects to achieve section 6323 status sometime in the future.<sup>95</sup>

In *United States v. New Britain*,<sup>96</sup> however, the Supreme Court

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<sup>92</sup> 340 U.S. at 50. Another case in which a private creditor's claim was subordinated to the federal claim because of failure to attain "choateness" is *United States v. R.F. Ball Constr. Co.*, 355 U.S. 587 (1958). There the competing creditor was a surety on a construction bond, to whom the taxpayer has assigned as collateral all sums to which he had a present or future claim under the bonded construction contract. The government had lost in the lower courts on its claim under the tax lien sections of the Internal Revenue Code. Offering little analysis, the Court reversed and ruled for the government, saying only that "the instrument involved being inchoate and unperfected, the provisions of § 3672(a) . . . do not apply." *Id.* at 587. Section 3672(a) of the 1939 Code was the predecessor of section 6323 of the 1954 Code. It provided that an assessment lien, arising under section 3670 of the 1939 Code (section 6321 of the 1954 Code) would not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof had been filed. All the *Ball* case apparently says is that a consensual security interest in future accounts receivable does not defeat the tax lien under the earlier version of section 6323. In *Crest Fin. Co. v. United States*, 368 U.S. 347 (1961), however, the government conceded in the Supreme Court that a creditor who held an assignment of existing and due accounts receivable, and who had sent notice of the assignment to the account debtors, did have a choate lien. That concession is particularly striking in view of the strong opinion for the government by the court of appeals relying on the *Ball* case in *Crest Finance*, 291 F.2d 1 (7th Cir. 1961). The distinction may be that *Ball* involved an assignment for future and, therefore, contingent indebtedness, where as *Crest Finance* involved an assignment for security of a present, existing debt.

<sup>93</sup> 340 U.S. at 50.

<sup>94</sup> *Id.* at 51.

<sup>95</sup> The Court in *Security Trust & Savings* discussed and rejected "the doctrine of relation back — which by process of judicial reasoning merges the attachment lien in the judgment and relates the judgment lien back to the date of attachment." *Id.* at 50.

<sup>96</sup> 347 U.S. 81 (1954).

awarded judgment to a local government on the ground that its tax lien, a statutory rather than consensual lien, was specific because it attached to specific parcels of real estate, so that under the Internal Revenue Code the lien was "perfected in the sense that there is nothing more to be done to have a choate lien . . . the identity of the lienor, the property subject to the lien, and the amount of the lien are established."<sup>97</sup> Absent legislation to the contrary, the *New Britain* Court continued, a lien that is "the first in time is the first in right."<sup>98</sup>

The only problem with this "first in time, first in right" test is that it does not indicate *when* a claim has ripened sufficiently to be "first." Thus, in *United States v. Buffalo Savings Bank*,<sup>99</sup> the Court cited *New Britain* but reached a contrary result. In *Buffalo Savings Bank*, a bank and the taxpayer executed a loan secured by a real estate mortgage. Thereafter, the United States filed notice of a tax lien, plus the liens for local taxes attached to the property. Subsequently, foreclosure proceedings were brought by the bank. The Court held the United States to have priority over the subsequently accruing liens for local real estate taxes, despite the fact that the federal lien was general in that it attached to all the taxpayer's property, including that already encumbered by the bank's mortgage.

The Court also applied the *New Britain* test in *United States v. Pioneer American Insurance Co.*,<sup>100</sup> where the federal government defeated a claim for attorneys' fees asserted under a private mortgage. The private creditor had commenced foreclosure proceedings against the real estate before the federal tax liens were filed, and the terms of the private mortgage extended the security to cover fees incident to the foreclosure action. The Court, applying the *New Britain* test, found that the mortgage was not choate because the amount of the lien had not been fixed at the time the tax lien was filed.

Congress seems to have tried in the 1966 Tax Lien Act to take the determination of perfection, or "choateness," away from federal law, leaving the states with the power to define the property rights that the Internal Revenue Code protects.<sup>101</sup> The legislation thus in-

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<sup>97</sup> *Id.* at 84.

<sup>98</sup> *Id.* at 85.

<sup>99</sup> 371 U.S. 228 (1963).

<sup>100</sup> 374 U.S. 84 (1963).

<sup>101</sup> Note, *Choateness and the 1966 Federal Tax Lien Act*, 52 MINN. L. REV. 198, 211-17 (1967).

dicates that federal laws, such as section 191 and its tests for choateness, are no longer determinative in tax cases. However, it remains unsettled whether Congress intended the Tax Lien Act of 1966 to bar completely the application of section 191 when only tax debts are involved.<sup>102</sup> Section 191 establishes a priority and has nothing to do with liens, whereas sections 6321-23 of the Internal Revenue Code apply only to taxes, do create a lien, and apply in all tax cases regardless of solvency.<sup>103</sup> Furthermore, the Supreme Court has hinted that tests for choateness are different for liens competing against a tax lien than for liens competing against a section 191 priority.<sup>104</sup>

There are therefore several unresolved problems about the relationship of the Tax Lien Act to section 191. Will the choateness test remain important to claims not protected by section 6323 that arose before assessment, and that could therefore, under a claim of being "first in time," assert priority over an assessment lien under Internal Revenue Code section 6321?<sup>105</sup> Will a choateness test have to be passed by a section 6323 creditor in order to prevail over a subsequent tax lien?<sup>106</sup> Does section 191 prevail over all liens?<sup>107</sup>

The government seems inclined not to litigate a claim under sec-

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<sup>102</sup> Coogan, *The Effect of the Federal Tax Lien Act of 1966 upon Security Interests Created Under the Uniform Commercial Code*, 81 HARV. L. REV. 1369, 1380, 1418 (1968). See, e.g., *Commissioner of Ky. Dep't of Revenue v. United States*, 383 F.2d 13 (6th Cir. 1967), which rejected the argument that section 191 should be read so as to be tempered by the amendments to section 6323. The state there was, however, neither a judgment lien creditor nor a creditor for real estate taxes, so probably it would have lost even if the court had applied section 6323. In another case the United States lost a claim to priority for a tax debt under section 191 over mortgages which were protected under section 6323. *Exchange Bank & Trust Co. v. Tubbs Mfg. Co.*, 346 F.2d 141 (5th Cir.), *cert. denied*, 355 U.S. 868 (1957). The Internal Revenue Code continues to recognize the priority of tax debts under section 191. See INT. REV. CODE OF 1954, §§ 6901 (a) (1) (B), 6901 (c) (3), 7421 (b) (2).

<sup>103</sup> *H.B. Agsten & Sons, Inc. v. Huntington Trust & Sav. Bank*, 388 F.2d 156, 160 (4th Cir. 1967), *cert. denied*, 390 U.S. 1025 (1968).

<sup>104</sup> *United States v. Vermont*, 377 U.S. 351, 357-58 (1964).

<sup>105</sup> Lacy, *supra* note 1, at 623.

<sup>106</sup> See *id.* at 633. The author there asserts that a section 6323 creditor should not have to pass a choateness test to defeat a subsequent tax lien. Since the section 6323 creditor could defeat a prior-in-time federal lien, it must, Lacy argues, be intended to prevail over one subsequent in time.

<sup>107</sup> On the one hand, Lacy argues that the federal claim should prevail over a mere private claim since it is of paramount importance that the United States be paid ahead of other creditors. This rationale is more persuasive applied to a liquidation of an insolvent business, after which the debtor is no longer in existence, than applied to the bankruptcy of an individual, from whom the government can still collect its non-dischargeable taxes. On the other hand, Congress did not see fit to give the United States a high priority in bankruptcy proceedings. So it can be argued that section 191 was not intended to prevail over all liens. *Id.* at 634.

tion 191 when the case would, except for insolvency, be covered by section 6323. Although such a claim might be asserted if there were large sums involved or if there were exceptional circumstances such as abuse by a fiduciary, the IRS appears to believe that it is unfair for the government to assert section 191 against creditors who have relied on section 6323 and perfection under the UCC, especially since section 6323 says the government will respect perfection under the UCC. This IRS practice leaves the government in a position of being required to file tax liens shortly after an indebtedness accrues in order to compete with private secured creditors. There is some apprehension that such early filing of tax liens could seriously impair the taxpayer's credit standing. On the other hand, it may be unfair to permit private lenders to remain ignorant of a prospective debtor's tax liability.<sup>108</sup>

#### IV. THE RELATIONSHIP BETWEEN FEDERAL PRIORITY AND STATE LAW

##### A. *Conflicting State Priority Choices*

There is such a welter of laws establishing schemes of priorities among the fifty states that we shall not attempt to discuss all possible alternatives. Many state priority rules are not clearly labeled as such, thereby leading to contradictions even within the system of one state. Thus, for example, article 3-A of the Lien Law of the State of New York<sup>109</sup> imposes a trust on funds to be paid or received in payment for construction on real estate.<sup>110</sup> The statute states that the purpose of the trust is to provide payments for specified costs related to the construction.<sup>111</sup> Although the expenses to be paid by the trust are listed in five sub paragraphs which suggest an order of importance, a later section within the same article of the statute provides that if an action is brought to enforce the rest of the

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<sup>108</sup> The competing policies behind the dispute on whether the government should pursue collection vigorously were discussed by the Congress, that ultimately chose to limit the priority for state taxes, thereby penalizing the government for failing to enforce obligations promptly. This legislation amended the priority for tax claims in bankruptcy proceedings, mentioned *supra*, note 71. The legislative history may be found at H.R. REP. NO. 687, 89th Cong., 1st Sess. 8-9 (1965), *reprinted in* 1966-2 CUM. BULL. 770; S. REP. NO. 999, 89th Cong., 2nd Sess. 6-7 (1966), *reprinted in* 1966 U.S. CODE CONG. & AD. NEWS 2442, 2448-51; S. REP. NO. 1158, 89th Cong., 2nd Sess. (1966), *reprinted in* 1966 U.S. CODE CONG. & AD. NEWS 2468-73; 111 CONG. REC. 18,961-62 (1965); 112 CONG. REC. 13,809-23 (1966).

<sup>109</sup> N.Y. LIEN LAW §§ 70 to 79-a (McKinney 1966).

<sup>110</sup> *Id.* § 70.

<sup>111</sup> *Id.* § 71.2.

article, then specified "classes of trust claims shall have preference, in the order named,"<sup>112</sup> the first of which is taxes withheld from the wages of the employees working on the job. The Court of Appeals of New York, in two cases decided on the same day, held that the United States does<sup>113</sup> and does not<sup>114</sup> collect ahead of mechanics' liens asserted under article 2 of the statute.<sup>115</sup> The cases can be reconciled, but by a hypertechnical, conceptual distinction between the real estate itself and a fund of money paid into court as a substitute for the real estate. Such distinctions may be mete for theoreticians, but they wreak havoc upon a businessman's planning.

### B. *The Property Rights Approach*

One way of dealing with statutes containing conflicting schemes of priority is to change the question from which claim has priority in an item of property to a question of whether property exists to which a given lien can attach. Thus, a decision that no item of property exists to which one of the statutory schemes would apply would leave only one set of distribution rules.<sup>116</sup>

This "property rights" approach has been used by the Supreme Court. The Court applied it in *United States v. Bess*<sup>117</sup> to determine the extent to which a lien for taxes owed by a decedent entitled the federal government to recover from the proceeds of the taxpayer's life insurance policy ahead of the beneficiary. The Court said that the government could collect only through its lien, since under state law, creditors would not have any right to enforce their claims against the beneficiary.<sup>118</sup> The lien could pro-

<sup>112</sup> *Id.* § 77.8.

<sup>113</sup> *Harman v. Fairview Assocs.*, 25 N.Y.2d 101, 250 N.E.2d 209, 302 N.Y.S.2d 791 (1969).

<sup>114</sup> *Onondaga Commercial Dry Wall Corp. v. 150 Clinton St., Inc.*, 25 N.Y.2d 106, 250 N.E.2d 211, 302 N.Y.S.2d 795 (1969).

<sup>115</sup> N.Y. LIEN LAW §§ 3 to 39-c (McKinney 1966).

<sup>116</sup> This approach was followed by a lower New York court that resolved a conflict between two articles of the Lien Law by holding that as a result of perfection of a mechanic's lien under one part of the statute, there was no fund to which the other part of the statute could attach consequences. *Hall v. Blumberg*, 26 App. Div. 2d 64, 270 N.Y.S.2d 539 (1965).

<sup>117</sup> 357 U.S. 51 (1958).

<sup>118</sup> *Id.* at 53-54. No issue was raised as to the power of Congress to create such a claim for the government if it chose to do so. This is an area in which Congress had *not* created a cause of action, thereby leaving it to state law. *Id.* at 56-57. Congress deliberately chose to allow state law to define the extent of the government's ability to collect taxes from transferees, even at the sacrifice of "uniformity of liability." *Commissioner v. Stern*, 357 U.S. 39 (1958). Justice Black dissented in *Stern*, joined by Justice Whittaker

fect the government only to the extent that the taxpayer owned property during his life to which the lien could attach, and although under the policy he had the right to designate and change the beneficiary, he never had the right to receive the proceeds himself, since they were not payable until his death. Under the insurance contract, however, he did have the right to surrender the policy and collect cash. The Court determined that this was a property right to which the lien could, and did, attach. The government was therefore given judgment against the beneficiary to the extent of the cash surrender value.<sup>119</sup>

*Bess* involved the government's right to collect from a person who had received assets from the taxpayer before the taxes were determined. In *Aquilino v. United States*<sup>120</sup> the Court went further and clearly articulated the principle that tax liens attach only to those assets which, under state law, are the property of the taxpayer. This may seem to be an obvious principle, until we examine the situation in which the Court applied it. The taxpayer, who was the general contractor for real estate improvements, failed to pay subcontractors and the federal government. The subcontractors filed notices of mechanics' liens shortly after the government had filed its notice of federal tax liens. In the state court action by the subcontractors to foreclose their liens, the owner of the real estate paid into court the money owing the general contractor, and the litigation continued with the United States substituted as defendant. The trial court held for the plaintiffs on the ground that the government had failed to file its notice of lien in the proper place.<sup>121</sup>

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and Chief Justice Warren, on the theory that because uniformity in the tax law is so important, it would require a clearer congressional expression to leave the law to vary among the states. *Id.* at 47-50.

<sup>119</sup> 357 U.S. at 58-59. The Court was constrained to justify this entirely reasonable result by characterizing the benefits as composed of two types of payment: the compensation for the loss insured against and a fund made up of the excess of the premiums paid in the early years of the policy over the actual risk in those early years. Although this analysis is an accurate description of the economics of insurance, it has no relevance in determining the competing creditors' claims to the proceeds. The analysis was not even necessary, since the Court had already ruled that "[t]he transfer of the property subsequent to the attachment of the lien [*i.e.* the payment of the proceeds of the policy to the beneficiary upon the taxpayer's death] does not affect the lien." *Id.* at 57. The concurring opinion would have arrived at the same result by enforcing against the beneficiary a lien on the cash surrender value. *Id.* at 59-60. The dissent found persuasive the argument that an insurance company's promise to pay cash surrender value terminated on the taxpayer's death and that, therefore, the property interest subject to the lien ceased to exist. *Id.* at 60-62.

<sup>120</sup> 363 U.S. 509 (1960).

<sup>121</sup> 140 N.Y.S.2d 355 (Sup. Ct. 1955).

The state appellate court affirmed, but on the ground that there had been no debt owed the taxpayer by the owner of the real estate and that, therefore, there was nothing to which the government's lien attached.<sup>122</sup> The court reasoned that the fund that was the subject matter of the litigation had been paid into court by the owner as a substitute for the land, and that because the United States had no lien on this land, since its claim was against the contractor-taxpayer, the government could not assert a claim to the fund.<sup>123</sup> The highest state court disagreed, however, and held that the tax lien had become effective as to the fund before the claims of the subcontractors.<sup>124</sup>

When the case reached the United States Supreme Court, the majority viewed it as involving a controversy over the kind of property right the taxpayer had.<sup>125</sup> It remanded the case to the state court for it to decide this question of "the nature of the property rights possessed by the taxpayer under state law," and to state clearly the extent to which it had looked to federal law in resolving the lawsuit.<sup>126</sup> Justice Harlan noted in his dissent,<sup>127</sup> however, that the Court was really giving the state the power to create rules of distribution that supersede conflicting federal rules.

*Aquilino* is unlike *Bess*, in which the Court recognized that

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<sup>122</sup> 2 App. Div. 2d 747, 153 N.Y.S.2d 268 (1956).

<sup>123</sup> Cf. *Harman v. Fairview Assocs.*, 25 N.Y.2d 101, 250 N.E.2d 209, 302 N.Y.S.2d 791 (1969); *Onondaga Commercial Dry Wall Corp. v. 150 Clinton St. Inc.*, 25 N.Y.2d 106, 250 N.E.2d 211, 302 N.Y.S.2d 795 (1969). This technique of looking to substitutions of kinds of property as an easy way out of thorny problems is an unfortunate way to resolve a dispute. Litigants will often need to substitute one asset for another, such as money for a machine, in order not to cripple normal operations which have nothing to do with the lawsuit, except that they require use of an asset against which the adversary asserts a claim. There is too much abrasiveness in litigation as it is, and the parties should be free to make these amicable adjustments unhampered by fear of prejudicial consequences. The problem is very acute when, despite the most careful planning, results can be upset by occurrences which have no real meaning to the substance of the transaction.

<sup>124</sup> 3 N.Y.2d 511, 146 N.E.2d 774, 169 N.Y.S.2d 9 (1957).

<sup>125</sup> 363 U.S. at 512. The subcontractors argued that the taxpayer had only "bare legal title" to the proceeds of its contract with the owner, while they, the creditors, held beneficial ownership to at least so much of the proceeds as was necessary to satisfy their claims. *Id.* at 515. The government had argued that the interest held by those creditors was nothing more than "an ordinary lien." *Id.*

<sup>126</sup> *Id.* at 515-16. On remand, the New York Court of Appeals held that the contractor did not have a sufficient beneficial interest in the monies due from the owner under the contract to give him property rights in them, except insofar as there would be a balance remaining after other statutory beneficiaries had been paid, and thus the federal government's tax lien against the taxpayer was ineffective to reach monies due the subcontractors. 10 N.Y.2d 271, 176 N.E.2d 826, 219 N.Y.S.2d 254 (1961).

<sup>127</sup> 363 U.S. at 516.

Congress had consciously refrained from establishing a federal rule, thereby leaving the area open to state regulation.<sup>128</sup> The taxpayer in *Aquilino* had a "property right" to receive payment under a contract. Under the reasoning of *Aquilino*, when a state legislature provides that certain creditors are to receive payment out of the proceeds of a contract, a court could say that the taxpayer's property is nothing more than his equity after satisfaction of those creditors, thereby compelling federal rules of distribution to defer to state rules.

The Second Circuit, however, in *United States v. Toys of the World Club, Inc.*,<sup>129</sup> interpreted *Aquilino* in a way that limits the delegation of power to the states to determine rules of distribution. The court stated that *Aquilino* shows "that the mere excess of a lien over the value of taxpayer's property is not enough to warrant a conclusion that the property no longer 'belongs' to the taxpayer . . . ."<sup>130</sup> In effect, this approach uses an interest in receiving the equity as a means of permitting the tax lien to cover the entire property.

*Bess* and *Aquilino* may be read to support the principle that property must be viewed as comprising what Judge Friendly has called a "bundle of rights,"<sup>131</sup> with each different right being a "property interest," some of which belong to the taxpayer and are therefore subject to a tax lien, while others do not belong to the taxpayer. Thus in *Bess* the lien attached to so much of the total insurance contract as represented the taxpayer's enforceable claim to receive cash surrender value, but did not attach to that part of the contract which represented the non-taxpayer beneficiary's right to receive benefits. From this perspective, the asset to be distributed in *Aquilino* was not a unitary asset, irrespective of whether that asset was considered to be the real estate or the taxpayer's right to be paid by the owner. Rather, there were rights to compensation in all the people involved in the construction contract — the owner, the general contractor, the sub-contractors, the suppliers, the laborers, and the taxing authorities.

Unfortunately, this kind of analysis will not make the fundamental problem disappear. The fact remains that the only existing

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<sup>128</sup> See note 118 *supra*.

<sup>129</sup> 288 F.2d 89 (2d Cir. 1961).

<sup>130</sup> *Id.* at 91. See also *Fine Fashions, Inc. v. United States*, 328 F.2d 419 (2d Cir. 1964).

<sup>131</sup> *Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962).



asset that could be taken was the limited sum the owner owed the general contractor. When a court holds that a given number of dollars represents one of the bundle of rights and is to go to the owner of that right, it is in fact directing distribution out of the total fund and thereby determining priorities.<sup>132</sup>

A further problem with the "property rights" approach applied in *Aquilino* and *Bess* is that those cases do not articulate a rule applicable in situations where federal law also purports to define property. Neither case mentions section 7501 of the Internal Revenue Code, which provides that income and social security taxes withheld by an employer from wages<sup>133</sup> are "a special fund in trust for the United States."<sup>134</sup> The employer must remit to the government the taxes withheld.<sup>135</sup> If he fails to do so, section 7501 carves a trust from his other assets, the beneficiary being the government. In effect, the Internal Revenue Code creates out of the taxpayer's assets a property right for the government to the extent necessary to satisfy the amount of taxes withheld but not paid over. Creating this "property right" is no different from establishing a scheme of priorities, as the Court has recognized,<sup>136</sup> but it is also no different from creating a property right under federal law, which should supersede conflicting state law.

In 1967, with *Commissioner v. Estate of Bosch*,<sup>137</sup> the Supreme Court further complicated the relationship between federal priorities and state law. It held that even in a situation in which it is clear that federal consequences, here estate tax, are determined by the character of a property interest under state law, and even when the courts of the state have defined the character of the property interest, federal courts can nevertheless re-examine the issue and, though applying state law, arrive at a different definition. Mr. Justice Clark, writing for the Court, first ruled that the principles of res judicata and collateral estoppel do not apply to the litigation in the

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<sup>132</sup> This determination of priorities can become particularly apparent in cases involving the circularity of lien problem. See, e.g., the discussion in the legislative history of the amendment to Bankruptcy Act § 67(c), 11 U.S.C. § 107(c) (1970), which attempted to resolve the circuitry problem. H.R. REP. NO. 686, 89th Cong., 1st Sess. (1965).

<sup>133</sup> "Employer" and "wages" are words of art in this context. They are defined in INT. REV. CODE OF 1954, §§ 3401(a), (d), to include anyone paying compensation for services, whether or not the payor is the person for whom the services are rendered.

<sup>134</sup> *Id.* § 7501(a).

<sup>135</sup> *Id.* § 3403.

<sup>136</sup> *United States v. Randall*, 401 U.S. 513 (1971).

<sup>137</sup> 387 U.S. 456 (1967).

Tax Court, because the government had not been made a party to a previous state court proceeding that determined the character of the property interest for probate purposes.<sup>138</sup> Then, because the litigation turned on application of a federal statute, the Court looked to the legislative history and concluded that Congress had intended state court determinations to be conclusive only when the determination was made "in a bona fide adversary proceeding," a finding that is to be made by a federal court.<sup>139</sup> Furthermore, the Court went on, federal case law indicates that even a decision made in an adversary proceeding free of all hint of collusion is, if made by any court lower than the state's highest appellate court, only one fact to consider,<sup>140</sup> along with decisions from courts of *other* states, in deciding how the state's highest appellate court would rule. The majority opinion concluded, in all seriousness, that "this would avoid much of the uncertainty that would result from the 'non-adversary' approach and at the same time would be fair to the taxpayer and protect the federal revenue as well."<sup>141</sup>

It seems a bit hard on taxpayers to allow the government to await the outcome of litigation in the state court while it remains free to reject any determination it dislikes<sup>142</sup> since it cannot be compelled to participate if it chooses to refrain.<sup>143</sup> Further problems may be present if there is no adversary for the taxpayer other than the federal government.<sup>144</sup> The problem is not that the fiduciary is

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<sup>138</sup> *Id.* at 463. The Court of Appeals for the Second Circuit had ruled that the government was bound by the state court determination because the state court had jurisdiction over the parties as well as over the subject matter, and the government could have intervened in that litigation. 363 F.2d 1009, 1014 (2d Cir. 1966), *rev'd*, 387 U.S. 456 (1967).

<sup>139</sup> 387 U.S. at 464.

<sup>140</sup> *Id.* See also *Miller v. Commissioner*, 299 F.2d 706, 708 (2d Cir. 1962), in which the court advocated referring to state property law in problems of statutory construction "for, if not the answer, at least a hint," on the presumption that Congress "had ordinary property concepts in mind."

<sup>141</sup> 387 U.S. at 465. The rule enunciated by the Supreme Court is presented more persuasively by Judge Friendly in his dissenting opinion in the court of appeals. 363 F.2d at 1015-19.

<sup>142</sup> See, e.g., *Pittsburgh v. United States*, 359 F.2d 654 (6th Cir. 1966).

<sup>143</sup> It is possible to get jurisdiction in limited kinds of lawsuits. 28 U.S.C. § 2410 (1970).

<sup>144</sup> This can easily happen. In Surrogate's Court proceedings, for example, the characterization of a power of appointment as general or special can have impact on availability of a marital deduction under federal estate tax law. The potential increase in tax liability will reduce the size of the estate available for distribution to the beneficiaries, so there is incentive for private parties to present a case for the power's being general. There will, however, be no one whose interests are served by presenting a case for the power's being special. This is what happened in *Commissioner v. Estate of Bosch*, 363 F.2d 1009 (2d Cir. 1966), *rev'd*, 387 U.S. 456 (1967).

without remedy, because there will almost always be a federal forum,<sup>145</sup> but that if federal rules of distribution are to be decided with reference to concepts of "property," and if "property interests" are to be redefined by federal courts according to their interpretations of state law, then uncertainty will burden taxpayers. Careful planning can be upset when a federal court uses its own experience and policy considerations to arrive at a result that was unanticipated during commercial negotiations among persons familiar with state court interpretations.

Two more problems with the property rights approach are suggested by *Bethlehem Steel Corp. v. Foley*,<sup>146</sup> another case involving the construction industry.<sup>147</sup> There, the taxpayer, who was the general contractor, had failed to pay a supplier, who, under New York law, had a right to repossess any supplies that had not been put into the construction. The supplier had not, however, exercised that right when the IRS filed liens for unpaid taxes and levied on those supplies. The government prevailed over the materialman's argument that "its right to repossess and remove under

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<sup>145</sup> Some taxpayers are not able to litigate in the Tax Court, either because they are barred by statute, INT. REV. CODE OF 1954, § 6871, or because the Tax Court lacks subject matter jurisdiction. The Tax Court has jurisdiction to determine "deficiencies," *id.* §§ 6214-15, which are defined to include only income, estate and gift taxes, and excise taxes on private foundations. *Id.* § 6211(a). This limitation precludes Tax Court litigation over withholding taxes, which in the experience of the authors is overwhelmingly the most common tax liability in insolvency proceedings. If there is no Tax Court jurisdiction, then the taxpayer must bring a refund suit, which requires payment of the entire amount of tax claimed by the government. *Flora v. United States*, 362 U.S. 145 (1960). In the case of employment taxes, the government generally will not object if the taxpayer pays the amount sought for one employee and sues for refund of that employee's taxes, thereby litigating the issue of all employees; except in extreme cases, the government will refrain from pressing the balance of its claim while the suit is pending. Nevertheless, a case can easily be imagined in which no court action to dispute the claim can be maintained. For example, a receiver of a liquidating company is given a proof of claim for income taxes in an amount greater than the estate. He cannot go to the Tax Court because he is denied access by INT. REV. CODE OF 1954, § 6871, and he is unable to pay the full tax so he cannot bring a refund suit. Nor will he be able to dispute the liability in an action to enjoin collection. *Id.* § 7421(a); *Enochs v. Williams Packing & Navigation Co.*, 370 U.S. 1 (1962). There is no jurisdiction in the federal district court to hear a suit for a declaratory judgment. 28 U.S.C. § 2201 (1970). No action for mandamus will lie because the receiver is not seeking to compel a purely ministerial act. This gap seems too horrendous for discussion in a mere footnote, but apparently it is not a practical problem since there do not seem to be any cases on it, unless of course the lack of cases is caused by the magnitude of the problem.

<sup>146</sup> 399 F.2d 314 (2d Cir. 1968).

<sup>147</sup> The construction industry is notorious for defaulted withholding taxes. In 1966, Congress added section 3505 to the Internal Revenue Code, Act of Nov. 2, 1966, Pub. L. No. 89-719, § 105(a), 80 Stat. 1125, making certain lenders responsible for their borrowers' failures to pay withholding taxes; the motivation for such unusual third party liability was supplied by the construction industry.

[state law] is a property right in the uninstalled materials which upon exercise extinguished the Internal Revenue Service lien which attached only to the property or interest in the property which the contractor then had."<sup>148</sup>

The court, analyzing the state statute and relevant legislative history, found that the law was intended to give a remedy to the creditor. The court recognized that the question involved the extent of the taxpayer's property rights since the tax lien attached only to the rights that the taxpayer had. But the court held that under New York law the materialman did not retain a property interest in the assets sold to the taxpayer; "rather, it seems likely that the legislature, without engaging in the use of property labels imbued with special meaning or legal consequences, merely intended that a right to repossess . . . materials should accrue . . . if and when the project is completed or abandoned."<sup>149</sup>

The first problem with this seemingly forthright approach is that it depends on a distinction between retaining an interest in the property transferred and reacquiring an interest after transfer of all the property. This distinction, relied on by the court, does not comport with reality. In one kind of transaction, property is transferred to a taxpayer who then transfers certain limited rights back to the transferor; in another, the transferor retains limited rights for himself and transfers only the balance of the asset to the taxpayer. There is no difference in result because ultimately both taxpayers are holding the same rights in the asset. The choice of the route taken can, however, make a substantial difference in the effect of a lien asserted against the taxpayer. If the first route is chosen and the lien becomes effective before the transfer back to the transferor, the lien asserted by the government will cover the entire asset.<sup>150</sup> If the second route is taken, the government's lien attaches only to the value of the property less the interest retained by the transferor. The critical question, then, is whether there was a reconveyance or only a transfer with a retained interest. But this could be either a state law issue because it is closely related to definitions of property, or a federal law issue because the answer determines the scope of a federal tax lien.

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<sup>148</sup> 399 F.2d at 316.

<sup>149</sup> *Id.* at 317.

<sup>150</sup> A tax lien will cover all property acquired by a taxpayer in the future. See text accompanying notes 18-24 *supra*. The lien would therefore attach to all the property at the instant it is conveyed to the taxpayer, and any reconveyance of the asset will be subject to that encumbrance.

A second problem raised by *Bethlehem Steel v. Foley* is that the case considers "property" as though it exists apart from its value. Although the court accepts the rule that the tax lien attaches only to the taxpayer's property, it fails to take into account the basic economic reality that what the taxpayer owned was not an unfettered right to the asset but a right limited by the creditor's right to repossess that asset. The court talks as though the taxpayer acquired a complete, exclusive interest, ignoring the right of the materialman to act, a factor diminishing the value of the taxpayer's property right.

This distinction is clearer if we look at what would happen upon sale of the asset by the taxpayer. If the taxpayer were to sell the asset, he would get a lower price for his interest if it is subject to a materialman's right to repossess. The result might be different if the materialman's right to repossess were terminated by a conveyance, so that a buyer could purchase a complete interest.<sup>151</sup> If under state law the creditor's right could be terminated by a conveyance to a bona fide purchaser, then we need be less concerned that the effect of the court's holding is that the filing of a federal tax lien cuts off the supplier's right to repossess, since the supplier's right to repossess is already limited by the chance of such a conveyance. If, on the other hand, the state law were that the right of the creditor survives such a conveyance,<sup>152</sup> the taxpayer and the creditor can both be accommodated if we apply a principle that splits the property rights economically, rather than one that identifies different rights in the property and transfers those rights separately. Such a division could be accomplished by appraising the rights of the competing creditors, selling the entire bundle of all the rights, and dividing the proceeds in the same proportion as the appraised value of each particular creditor's claim bears to the appraised value of the whole.

Suppose, for example, that a person who owes the government more than \$15,000 in taxes owns a custom-built Cadillac with an appraised value of \$15,000, and that the owner-taxpayer also owes a bank \$11,000 on a note secured by the car. Assume further, however, that there is some doubt as to the validity of the bank's lien

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<sup>151</sup> Conceptually, this would be equivalent to a rule under which a seller could, in effect, convey more than he himself owned. Such conceptual anomaly should not, however, be an insurmountable obstacle if the rule works otherwise.

<sup>152</sup> We recognize that under the many state laws, the interest might be extinguished by certain conveyances but survive other events. An analysis of the subtleties of different hypothetical occurrences is beyond the scope of this Article.

and that this doubt reduces the appraised value of the bank's claim to \$10,000.<sup>153</sup> The value of the government's interest in this asset would then be the \$5,000 balance. If the sale of the car nets<sup>154</sup> \$9,000,<sup>155</sup> the government would be paid five-fifteenths of the \$9,000, or \$3,000, and the bank would receive ten-fifteenths, or \$6,000.

### C. *The Uniform Commercial Code*

A significant inter-relationship between state and federal law, in terms of everyday commerce, is in the area of security interests created under the UCC, a statute solicitous of the needs of secured creditors.<sup>156</sup> Thus, under the UCC, the filing of a security interest protects the creditor's interest in the collateral,<sup>157</sup> and it attaches when the creditor has given value and the debtor has acquired rights in the collateral.<sup>158</sup> A financing statement may not give a fully perfected lien when filed, but if it is subsequently perfected, that perfection will relate back to the time of filing.<sup>159</sup>

In the area of federal law, the Supreme Court has rejected the possibility that subsequent perfection can be related back to protect a private lienor from the government's priority.<sup>160</sup> Nevertheless, it appears that Congress has accepted the notion that a lien may be perfected although the amount remains uncertain because no advances have yet been made, and although the property subject to the lien is still uncertain because the debtor has not yet ac-

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<sup>153</sup> This kind of evaluation of litigation hazards is made every day by lawyers in deciding for how much to settle a case. The fact that an appraisal is not a precise figure, but only an approximation, is not reason to reject appraisal.

<sup>154</sup> The expenses of the sale should be deducted before the prorating is done. Each creditor would then be contributing his proportionate share of the expenses — in other words, each would be paying to the extent he was benefited by those costs.

<sup>155</sup> There are many reasons why the sale may yield less than an appraisal. Appraisals can be of "going concern" value, "orderly liquidation" value, or "forced sale" value. Since we use the appraisal value only for a basis for proration, it does not matter which we take.

<sup>156</sup> One writer has asserted that secured creditors are entitled to greater protection than unsecured creditors because they see to it that the unsecured creditors, who supply day-to-day needs, are paid. Gordon, *Unconscionability in Bankruptcy: The Federal Contribution to Commercial Decency*, 66 Nw. U.L. REV. 741, 758 (1972). We have seen little evidence to support this suggestion of secured creditors' altruism.

<sup>157</sup> UCC §§ 9-302, -303.

<sup>158</sup> *Id.* § 9-203 (1972 version).

<sup>159</sup> *Id.* § 9-312(5)(a).

<sup>160</sup> *United States v. Security Trust & Sav. Bank*, 340 U.S. 47, 50 (1950), discussed in text accompanying notes 91-95 *supra*.

quired it.<sup>161</sup> These uncertainties would, under traditional federal law, render the lien highly susceptible to government attack as inchoate.<sup>162</sup>

This Article will not begin to analyze the UCC, whose mystery is surprisingly underestimated by practitioners.<sup>163</sup> What is clear is that the legislatures that enacted it articulated a strong desire to favor secured creditors. For example, the UCC gives a secured creditor the right, in the event of insolvency proceedings, to take the debtor's cash and bank accounts to the extent of cash received in the ten days before the proceedings are begun.<sup>164</sup>

We can appreciate how startling this favoritism is, when we compare this section to sections 60 and 67(a) of the Bankruptcy Act,<sup>165</sup> under which many transfers<sup>166</sup> to unsecured creditors within the four months before inception of the proceeding can be recovered by the trustee. Under the Bankruptcy Act the Supreme Court has refused to permit the government to attach a bank account unless it is able to trace the dollars in that account, in spite of a federal statute<sup>167</sup> specifically imposing on the bank account a trust for the benefit of the United States.<sup>168</sup>

It is also instructive to contrast this solicitude for the secured creditor, who should be in a good position to protect himself and who entered into the transaction in order to make a profit, with the treatment given the pre-paying buyer, often a helpless consumer, when the seller becomes insolvent before delivering the purchased goods.<sup>169</sup>

## V. OBSERVATIONS AND CONCLUSIONS

We shall eschew the temptation to offer a "conclusion" evaluating the government's priority as "good" or "bad." Apart from our reluctance to moralize, we are aware that any such evaluation

<sup>161</sup> Note, *supra* note 101, at 210, giving citations to the legislative history.

<sup>162</sup> See text accompanying notes 3-7 *supra*.

<sup>163</sup> See Mellinkoff, *The Language of the Uniform Commercial Code*, 77 YALE L.J. 185 (1967).

<sup>164</sup> UCC § 9-306(4)(d).

<sup>165</sup> 11 U.S.C. §§ 96, 107(a) (1970).

<sup>166</sup> "Transfer" is defined in the Bankruptcy Act as broadly as possible and includes granting a security interest. *Id.* § 1(30).

<sup>167</sup> INT. REV. CODE OF 1954, § 7501(a).

<sup>168</sup> *United States v. Randall*, 401 U.S. 513 (1971).

<sup>169</sup> Schrag & Ratner, *Caveat Emptor — Empty Coffers: The Bankruptcy Law Has Nothing to Offer*, 72 COLUM. L. REV. 1147 (1972).

could be met by persuasive contrary ones, derived from competing theory, practical considerations, or precedent. We shall, however, make some observations.

First, it is important to keep in mind the true significance, in terms of dollars, of what we are dealing with. The proportion of an estate that goes to taxing authorities compared to that going to other creditors is smaller than one would surmise from the heat generated in discussions of the federal government's priority. The relevant figures should correct any misimpression that the government dominates the distribution.<sup>170</sup> One fact demonstrated by these

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		Year Ending June 30				
		1965	1966	1967	1968	1969
Straight Bankruptcies Concluded	Total*	152,915	175,227	181,326	187,206	163,827
	Asset Cases	18,513	18,532	19,144	21,360	22,355
	Nominal & No. Asset Cases	127,142	136,667	141,012	143,046	131,258
Payments in Relation to Proceeds Realized by Estate	Admin. Fees & Expenses	\$24,905,409 (25.7%)**	\$24,617,313 (24.8%)	\$23,803,515 (22.8%)	\$22,517,054 (24.5%)	\$26,446,037 (23.4%)
	Secured Creditors	\$28,444,911 (29.4%)	\$32,427,785 (32.6%)	\$35,997,004 (34.5%)	\$30,460,665 (33.1%)	\$37,499,860 (33.1%)
	Wages	\$ 2,157,072 (2.2%)	\$ 2,100,433 (2.1%)	\$ 1,877,529 (1.8%)	\$ 1,637,766 (1.8%)	\$ 2,029,528 (1.8%)
	All Taxes	\$10,776,094 (11.1%)	\$11,224,590 (11.3%)	\$ 9,740,973 (9.3%)	\$ 9,534,138 (10.3%)	\$11,220,470 (9.9%)
	Other Priority	\$ 1,698,124 (1.8%)	\$ 1,464,061 (1.5%)	\$ 1,195,326 (1.1%)	\$ 1,136,555 (1.2%)	\$ 1,448,594 (1.3%)
	Unsecured Creditors	\$24,213,866 (25.0%)	\$24,194,351 (24.3%)	\$27,571,008 (26.4%)	\$23,164,977 (25.2%)	\$30,810,542 (27.2%)
	Other Payments	\$ 4,580,840 (4.7%)	\$ 3,358,693 (3.4%)	\$ 4,052,929 (3.9%)	\$ 3,578,603 (3.9%)	\$ 3,681,785 (3.3%)
Amounts Paid to Classes of Creditors and Percentage of Allowed Claims Paid	Secured	\$28,444,911 (60.7%)***	\$32,427,785 (62.6%)	\$35,997,004 (72.0%)	\$30,460,665 (70.1%)	\$37,499,860 (76.4%)
	All Priority	\$14,631,245 (37.6%)	\$14,789,084 (36.7%)	\$12,813,819 (34.0%)	\$12,308,462 (34.0%)	\$14,698,600 (34.1%)
	Unsecured	\$24,213,866 (7.5%)	\$24,194,351 (6.9%)	\$27,571,008 (7.5%)	\$23,164,977 (6.8%)	\$30,810,542 (7.8%)

\* Includes cases dismissed.

\*\* These percentage figures represent the percent of proceeds realized, *i.e.* \$24,905,409 was paid for administrative fees and expenses, which was 25.7 percent of the estate.

\*\*\* These percentage figures represent the percent of the claims paid, that is, Secured Creditors were paid a total of \$28,444,911, which represented a 60.7 percent payment of secured claims.

These figures are drawn from tables F 4a, F 5 and F 6, ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, TABLES OF BANKRUPTCY CASES COMMENCED AND



statistics is that in 1969, a typical year, all taxing authorities — state, local, and federal — collected less than \$11.25 million, which represented under ten percent of the total realized from bankruptcy estates. This percentage was a poor fourth after the amounts paid to secured creditors (who came out best, with nearly a third of all the property administered), to the fiduciaries administering estates, and to general creditors.

Although the amount of revenue raised by virtue of the federal priority, as demonstrated by these statistics, is not great, revenue raising is the historic purpose of the priority.<sup>171</sup> While this historic rationale of the priority may be challenged, the argument for retention of the priority is buttressed nonetheless by the ability of the priority to serve two other important functions as well, a sanction and deterrent function, and a ceremonial function.

The importance of the sanction and deterrent function is apparent when the role the priority rules play in meeting the collection problems encountered by the government is considered. Procedures for collecting directly from debtors are beyond the scope of this Article, which views the Federal priority in the context of collecting a debt from persons other than the debtor himself, specifically persons administering the estate of the debtor.<sup>172</sup> The priority rules are part of a broad statutory scheme for enforcing liabilities against third parties who have, honestly or otherwise, gained possession of the debtor's property. The insolvency priority, section 191, is complemented by section 192,<sup>173</sup> which states:

Every executor, administrator, or assignee, or other person, who pays, in whole or in part, any debt due by the person or estate for whom or for which he acts before he satisfies and pays the debts due to the United States from such person or estate, shall become answerable in his own person and estate to the extent of such payments for the debts so due to the United States, or for so much thereof as may remain due and unpaid.

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TERMINATED IN UNITED STATES DISTRICT COURTS DURING THE FISCAL YEAR JUNE 30, 1965 and from these tables for the years 1966-1969. Payments to the federal government are not separately stated; they are included with state and local taxing authorities in the column "all taxes," and with other creditors entitled to a fifth priority under Bankruptcy Act § 64(a)(5), 11 U.S.C. § 104 (1970) in the column, "other priority."

<sup>171</sup> The priority statute was to be broadly construed to achieve this purpose. *United States v. State Bank*, 31 U.S. (6 Pet.) 29, 35 (1832). The doctrine of the unperfected lien was developed in response to fears that state legislatures could, by defining liens, substantially impede collection by the federal government. *United States v. New Britain*, 347 U.S. 81, 86 (1954).

<sup>172</sup> Section 191 does not apply so long as a debtor is in possession of his own property, no matter how insolvent he is. *Beaston v. Farmers' Bank*, 37 U.S. (12 Pet.) 102, 133 (1838).

<sup>173</sup> 31 U.S.C. § 192 (1970). *See also* 28 U.S.C. § 959 (1970).

Section 192 has been construed to impose personal liability even when the fiduciary had obtained a court order directing the payment to the junior creditor,<sup>174</sup> although the extent of the liability is limited by the size of the estate at the time the claim is asserted.<sup>175</sup>

The Internal Revenue Code has characteristically elaborate provisions defining the responsibility of a "fiduciary," a term which, though broadly defined, is not all-inclusive.<sup>176</sup> The fiduciary must notify the IRS of his qualification<sup>177</sup> and is responsible for the tax obligations of the taxpayer, including the obligation to file returns.<sup>178</sup> The government may collect a tax from the transferee of the taxpayer's property by the same assessment and collection procedures available to it when proceeding against the taxpayer directly.<sup>179</sup>

If these provisions, combined with the priority given the federal government, seem to be an example of over-kill, consider the government's problem when a delinquent taxpayer turns out to be insolvent. The government must try to collect from whomever has the property that should in one form or another have been used to pay taxes. The government is, however, at a serious disadvantage since it lacks the information necessary to identify the taxpayer's transferees.<sup>180</sup> In most private lawsuits, each party knows at least his own version of what happened, but in the government's collection suit all the facts and evidence are in the hands of the adversary. This situation is not unlike an executor of a decedent's estate trying to bring a wrongful death action without witnesses.

The government is also at a disadvantage in policing its debts. Unlike trade creditors who are attentive to the daily needs of their debtors and who are constantly involved in the collection of accounts receivable, the government is usually not involved in the day-

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<sup>174</sup> *King v. United States*, 379 U.S. 329 (1964).

<sup>175</sup> *Want v. Commissioner*, 280 F.2d 777 (2d Cir. 1960).

<sup>176</sup> "The term 'fiduciary' means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person." INT. REV. CODE OF 1954, § 7701(a)(6). It does not include an agent, even if he has "entire charge of property . . . merely turning over the net profits from the property periodically to his principal . . . ." Treas. Reg. § 301.7701-7 (1960).

<sup>177</sup> INT. REV. CODE OF 1954, § 6036.

<sup>178</sup> *Id.* §§ 6012(b), 6903. See also 28 U.S.C. § 960 (1970).

<sup>179</sup> INT. REV. CODE OF 1954, § 6901(a). There are provisions extending the statute of limitations on such collection. *Id.* §§ 6901(c)-(f). Compare *id.* § 6901(a) with *id.* § 6672, the so-called 100 percent penalty, which makes employers personally liable for withheld taxes. The effect of section 6672 is that the officers of a bankrupt corporation will be required to pay any withholding taxes that are not paid on distribution of the estate.

<sup>180</sup> The government will have the burden of proof. *Id.* § 6902.

to-day operations of its debtors and is therefore likely to be among the last to learn of the debtor's financial problems. The creditors who discover such problems last are the last to enforce collection, and some statutory protection is necessary lest no property be left. While government collection may be painful to the private creditors at whose expense the government takes payment, nevertheless the government represents all taxpayers and it is their money that is being sacrificed.<sup>181</sup> Protecting parties who are not in a position to protect themselves is an appropriate judicial function.<sup>182</sup>

The "ceremonial function" of federal priority suggests values that come from according the sovereign a certain respect greater than that given private parties in the marketplace. Ultimately, the integrity of our tax system, being one of self-assessment, depends on the integrity of the taxpayers. In our experience, the psychological importance of according a priority to the sovereign is of great significance in maintaining the respect necessary for the system to work. People can be expected to do what is pleasant, and there is nothing pleasant about paying taxes. Indeed, it is often hard to find any rational justification for the sacrifice the payment entails. To some extent, though, people are inherently law-abiding, and the priority probably serves a psychological purpose by affording the gratification that one is doing the right or at least the lawful thing. Without the priority, we might expect to see a greater failure to pay even the diminished amount.

Aside from the issue of whether the priority should exist or not, it should meet other criteria if it is to operate. A statute operates detrimentally when businessmen are either unable to comply with the law or cannot plan their actions according to it intelligently because its operation is subject to unpredictable contingencies. What we are really asking is that a given statute be clear and uniform in its application.<sup>183</sup>

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<sup>181</sup> See *Bramwell v. United States Fidelity & Guar. Co.*, 269 U.S. 483, 487 (1926) (section 191 is to be liberally construed because it protects the public good).

<sup>182</sup> For an extreme statement of this position, see Gordon, *supra* note 156, suggesting that the bankruptcy court should exercise its potential for playing an active role in the development of commercial law and practices through invalidation of security interests on grounds of unconscionability, in order to protect the public interest, as well as the interests of the debtor and creditors.

<sup>183</sup> By "uniform in operation" we mean that the same result should follow regardless of whether the assets of a private creditor's debtor are administered in an assignment for the benefit of creditors, a bankruptcy proceeding, a foreclosure, or a suit to reduce a tax lien to judgment. The rules of section 6323 of the Internal Revenue Code are important when there is not enough money to pay all competing creditors, and if they are to apply at all, the creditors should be able to know they will apply in all cases. We are,

The problem is that we must use words to establish the priority rules, and examination reveals that those words have less content than one would guess from their illusion of certainty. The word "lien" connotes one kind of priority rule. To say, for example, that a lien is valid against a trustee in bankruptcy means that the claim represented by the lien will be paid ahead of the claims of the creditors whom the trustee represents.<sup>184</sup> "Lien" is a symbol for a particular kind of property claim to which others must defer, but it is a symbol used without agreement on its definition or its function in particular situations. When courts seek to determine whether a given creditor has a "lien," they really determine whether he has taken the necessary action to give him preferred status. There is, however, a judicial tendency to see a "lien" as a thing that exists in absolute terms, apart from its context.

The criteria that define "lien" in one case may not be relevant in another case involving different statutes and different competing claims. Therefore, it is of little help to adopt a method of analysis that merely imports a finding of "lien" from another context. What is necessary is an examination of where one creditor stands in relation to other creditors, realizing that there are many different kinds of "liens" and realizing further that a determination that any particular creditor has a "lien" may give sufficient information to answer the question of the priorities among all creditors.

The harm caused by an absolutist conception of the word "lien" is that it produces a rigidity that freezes relationships at a given point in time. Commerce is a dynamic continuum of relationships, and a creditor's rank rises and falls in relation to other creditors as he moves through time, selling, extending credit, and taking action to collect on the debt. A viable priority rule cannot depend on a static relationship between only two parties.

Equally important as the vitality of commerce, though, is the

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therefore, at something of a loss to understand the enormous effort put into proposing amendments to section 191, when the statute as amended is to apply only to tax cases. *The Federal Priority in Insolvency*, *supra* note 1, at 96-97. Similarly, it seems that a more troubling inconsistency exists between INT. REV. CODE OF 1954, § 6323 and the Bankruptcy Act's scheme for priority, than between section 191 and Bankruptcy Act § 64, 11 U.S.C. § 104 (1970).

<sup>184</sup> A "lien" affects not only the debtor and the creditor claiming the lien. Because it is important in situations where the debtor does not have sufficient property to pay all his debts, it has substantial impact on the debtor's other creditors. The impact of a lien in relationships among many parties, most of whom were not parties to the transaction creating the lien, must not be overlooked, and this is true of all liens, not just consensual liens. It is because of the importance of focusing on the broad spread of this impact that common definitions of "lien" are so unsatisfactory. See note 19 *supra*.

need for certainty. The burden to a commercial lender may be more than the purely financial one of subordinating one private debt to another. The burden of uncertainty can be just as intolerable to a commercial lender. A burden on a lender is quickly translated into a burden on a borrower because risks will be translated into credit costs, and certain marginal borrowers will be unable to obtain loans, while better situated borrowers will be forced to pay the higher costs.

Without intending to disparage the distress of a debtor's bankruptcy on a creditor, it is not unfair to emphasize that the impact of a creditor's loss is frequently exaggerated. The loss should be viewed in the context of the total operations of a creditor. The risk of loss is a factor in the entire debt pricing operation, so that when default occurs, it has usually been foreseen as a cost of doing business. A government subsidy to provide for the insolvency of a defaulting debtor might be either a windfall for the creditor who planned efficiently or a prop for the inefficient creditor.<sup>185</sup>

The economic impact of the government's priority, like that of any priority rule, may be sketched in only the broadest theoretical terms. It should seem obvious that any determination of this impact must be made by Congress, not by the courts.<sup>186</sup> It is essential that Congress cut through the theory and emotion that have often characterized analyses of federal priority and learn what businessmen actually do when extending credit. It may well be that the government's priority plays virtually no role at that stage of the credit transaction. If Congress decides that public assistance to creditors is appropriate at the opposite end of the credit transaction, that is, upon the insolvency of the debtor, then such assistance should be rendered by paying a subsidy to creditors. Only in this way

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<sup>185</sup> There are significant benefits for creditors presently in the tax law, in addition to their bad debt deductions. The debtor's tax loss carrybacks generate refunds which may be applied to the private debt. The loss carryovers are used to shelter income which is thus freed for payment to private creditors. Some insolvency reorganizations are already tax-free under section 371 of the Internal Revenue Code, at the small price of a basis adjustment under section 372. Other tax-free distributions can be accomplished under usual corporate tax law. See Tillinghast & Gardner, *Acquisitive Reorganizations and Chapters X and XI of the Bankruptcy Act*, 26 TAX L. REV. 663 (1971). As a benefit to the debtors, there is very little tax consequence to the discharge of indebtedness, in spite of the provision in section 61(a)(12) of the Internal Revenue Code that "income from discharge of indebtedness" is income. This entire area is extraordinarily complicated, and one sorely needed improvement is a simplified, clear statement of the tax law governing reorganizations.

<sup>186</sup> This is true not only because Congress has the responsibility to establish policy, but also because "Congress has the fact-gathering facilities necessary for an appropriate

can the general public be aware of what is being done. If the assistance is buried in priority rules, one cannot measure in terms of dollars spent the benefit to the creditors and the cost to the government. Of equal importance, this means of giving relief would identify the creditors benefitting from the subsidy. The public might feel differently about the federal priority if it learns that the creditors to whom the government is subordinated are the corporate megaliths and the banks.

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gauging of the impact of a decision. . . ." *United States v. General Douglas MacArthur Senior Village, Inc.*, 470 F.2d 675, 679 (2d Cir. 1972).

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